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IN THE MATTER OF THE COMPETITION
IN THE PROVISIONS OF ELECTRIC
SERVICES THROUGHOUT THE STATE OF
ARIZONA

94
DOCKET NO. U-0000-96-165COMMENTS BY
CITIZENS UTILITIES COMPANY

Citizens Utilities Company ("Citizens" or "Company") hereby submits to the Arizona Corporation Commission ("Commission") its written comments in response to the draft rules proposed by the Commission Staff ("Staff") in its letter of August 28, 1996 in this docket. The draft rules, which set forth a suggested framework for the introduction of retail electric competition in Arizona, was prepared by Staff after taking into account opinions expressed at a workshop held on August 12, 1996, and reviewing comments filed in June 1996 by participants in this case. Citizens was a participant in the workshop and previously had submitted written comments.

Citizens is an enthusiastic advocate of rapidly transitioning the electric industry to an environment that is more competitive and driven by customer needs. However, the success of this transition, and the future of the electric industry in general, will be dependent on the rules that are drafted to guide utilities in this new environment. It is particularly troubling, therefore, that a limited, initial comment period has been provided to review the significant and far-reaching changes being proposed. Even within the limited time constraint, Citizens has been able to identify issues of constitutional law, policy direction, and practical implication, which will cause Staff's proposal to fail unless material revisions to the proposed rules are made.

First, the provisions regarding stranded cost recovery are of questionable legality. They also suffer from numerous deficiencies that conflict with one of the Commission's

1 identified objectives in this docket, namely that the introduction of competition should limit the
2 potential harm to utilities and utility investors.¹

3 Second, the proposal would increase the burdensome degree of regulation both during
4 the transition to competition and the period after which competition is formally established.
5 Such regulation would undermine another of the Commission's objectives -- to limit the
6 potential for market impediments.

7 Third, the draft rules also purport to grant to the Commission powers that can only be
8 exercised by the Federal Energy Regulatory Commission ("FERC").

9 Fourth, the draft rules would create an unlevel playing field between Affected Utilities
10 (as defined in the proposal) and other market participants. By skewing the framework of the
11 restructured electric industry, the rules would be in conflict with yet another of the
12 Commission's stated objectives, namely to encourage a variety of market developments.

13 Finally, the proposal would needlessly duplicate initiatives already in progress
14 regarding system reliability and safety.

15 These comments will outline Citizens' initial concerns with these issues. A more
16 detailed response will be submitted by Citizens to the Commission's formal promulgation of
17 proposed rules for comment.

18 19 STRANDED COSTS

20 CITIZENS' POSITION

21 In its submission of June 28, 1996, Citizens proposed that the Commission rely on an
22 auction as the best means of establishing the amount of stranded costs² associated with
23 generation and purchased power assets. That proposal assumes that all reasonable efforts
24 to mitigate strandable costs have already been made. Existing utilities and all independent
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26 ¹ See Request for Comments on Electric Industry Restructuring, dated February 22,
27 1996.

28 ² As used in these comments, the term stranded costs include both expenses and
capital investments.

1 power producers would be paid 100% of original cost less depreciation for generation assets.
2 As an alternative, such entities would have the option of retaining all generating assets for
3 entry into the power market. With the auction establishing an objective frame of reference
4 for determining stranded costs,³ Citizens' proposal envisions the refinancing of stranded costs
5 through low-cost state obligation bonds. Finally, stranded costs would be recovered through
6 a statewide Investment Recovery Fund Surcharge.

8 **THE STAFF PROPOSAL (A.A.C. R14-2-XXX7)**

9 The Staff proposal to address the recovery of stranded investment, as set forth in
10 A.A.C. R14-2-xxx7, is deficient in several respects.

11 **The proposal fails to adequately address stranded costs arising from** 12 **sources other than generating assets.**

13 The Staff proposal defines stranded investment as "the verifiable net difference
14 between the value of all the prudent jurisdictional assets under traditional regulation of
15 Affected Utilities and the market value of those assets directly attributable to the introduction
16 of competition under this Article." A.A.C. R14-2-xxx1(5) (emphasis added). That definition
17 and proposed rule A.A.C. R14-2-xxx7 fail to adequately cover the strandable costs that may
18 arise from sources other than assets and investment in generating plant. For instance,
19 purchased power contracts (which may be above-market), demand side management, and
20 other regulatory assets (i.e., expenses incurred by the utilities that the Commission has
21 required them to defer) all may give rise to stranded costs under a competitive electric utility
22 model.

23 This distinction has serious practical implications for Citizens, which has only limited
24 generating assets and must rely primarily on purchased power contracts to meet its capacity
25 and energy requirements. Citizens would be placed at a substantial disadvantage if the issue

26 ³ The difference between the proceeds from the auction and the total net book
27 value, plus the difference between original purchase power contract prices and
28 prices obtained in the auction, would constitute stranded costs for generation and
purchased power contracts.

1 of stranded costs recovery were to be solely dependent on whether an Affected Utility
2 owned its own generating plants. To remedy this shortcoming in Staff's draft rules, the
3 proposal should be clarified so that the term stranded costs includes purchased power
4 contract costs and such costs be subject to recovery.

5 **Staff erroneously concludes that the Commission retains the discretion**
6 **to disallow recovery of unmitigated Stranded Investment by Affected**
7 **Utilities (Sections B, E, and I).**

8 A.A.C. R14-2-xxx7(B) states that "the Commission may allow recovery of unmitigated
9 Stranded Investment by Affected Utilities." Similarly, Section E suggests that stranded cost
10 recovery would be determined on a utility-by-utility basis only after the Commission balanced
11 numerous competing stockholder and customer interests. Besides the discretion and
12 balancing standards, Section I provides a cutoff date for stranded cost recovery of year-end
13 2004.

14 Each of these sections proceeds on the faulty premise that the Commission has the
15 discretion to disallow prudently incurred costs. Instead, the well-settled standard is that the
16 Commission must allow utilities a reasonable opportunity to recover prudent investments and
17 expenses associated with the provision of utility service. Disallowance of these investments
18 and expenses is not only unconstitutional, but it also violates the regulatory compact between
19 regulators and utilities.

20 With respect to the unconstitutional nature of any stranded cost recovery disallowance,
21 such action would violate the Fifth Amendment to the U.S. Constitution's proscription against
22 a governmental taking of private property without just compensation, and cases decided
23 thereunder. While the standard traditionally applied is the effect of regulation and not the
24 method employed, a regulatory structure that precludes a utility from recovering a necessary
25 cost of doing business is indeed a taking.

26 Disallowance of stranded costs would also violate the regulatory compact between the
27 regulator and the utility. Utilities have made expenditures and investments pursuant to their
28 statutory and regulatory obligations with the express understanding that they would be

1 allowed to recover them and earn a reasonable return on them, provided they were prudent.⁴
2 Now that the costs have already been incurred for the benefit of the public, the proposed
3 rules would have the effect of changing the terms of the bargain by depriving utilities (and
4 their investors) of the ability to recoup their costs. Well-settled precedent has established
5 that the Commission cannot renege on its end of the bargain after the utilities have fulfilled
6 their commitment.

7 It is not the intent of these comments to present a full analysis of the legal arguments
8 underlying the above points. Should the need arise, comments at a later stage of this
9 proceeding will discuss the legal impediments to the discretionary balancing approach to
10 stranded cost recovery set forth in the draft rules. For the purposes of this filing, the
11 Company merely intends to place Staff on notice that any proposed rules that stray from the
12 full cost recovery standard described above are legally infirm. Finally, any rulemaking that
13 provides less than full recovery of stranded cost is assured to delay any benefit of
14 competition due to legal actions that would be initiated by utility investors and the utility
15 industry to block such rules.

16 **No reference is made to appropriate cost recovery in the discussion of**
17 **accelerating depreciation of assets (Section A).**

18 Section A of A.A.C. R14-2-xxx7 would require Affected Utilities to mitigate or offset
19 Stranded Investment with mitigation measures, a concept with which Citizens generally
20 concurs. One of the mitigation measures identified in Section A is "accelerated depreciation
21 of assets." While accelerated depreciation would surely reduce the balance of stranded
22 costs, it must be accompanied by appropriate cost recovery mechanisms so that the utility
23 can be made whole for its prudently incurred investment. Otherwise, the draft rules would
24 amount to a disallowance of stranded costs, as discussed above. In addition, accelerated
25 depreciation would not address liabilities such as purchased power contracts.

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27 ⁴ Proposed rule A.A.C. R14-2-xxx1(5), which sets forth definitions for the Article,
28 expressly recognizes that in order to qualify as "Stranded Investment", the
expenditure must be prudently incurred.

1 **Staff bases its calculation of stranded costs on estimates, instead of**
2 **allowing for the auction process proposed by Citizens (Section C).**

3 In Section C, Staff proposes to rely on estimates to calculate stranded costs. While
4 there is language in the draft rules suggesting a degree of precision in these estimates
5 (namely, "fully supported by appropriate analyses and by market transactions undertaken by
6 willing buyers and willing sellers"), the proposal would require utilities, other participants and
7 ultimately the Commission to engage in speculation about a component worth billions of
8 dollars in Arizona.⁵ So that there can be no misunderstanding, Citizens is not reluctant to
9 project its level of investments or costs because it retains some measure of control in this
10 area. Predicting stranded investment (or costs) is an entirely different matter, since it would
11 require utilities to speculate about the market price of energy and capacity, two components
12 over which they exert no measurable control.

13 To avoid this shortcoming, Citizens proposed an auction process to determine in a far
14 more precise manner the level of stranded costs. Under Citizens' proposal, there could be
15 no dispute about the amount of stranded costs because the approach would be market-based
16 (rather than relying on very limited market transactions to support estimates ultimately
17 determined by an administrative agency, as the draft rules currently read). Accordingly, the
18 draft rules should be revised so that utilities will not be forced to prognosticate market prices.
19 Instead, Staff should revise the draft to incorporate a more reliable method of determining
20 market value, such as that proposed by Citizens.

21 **Staff's proposed mechanism to recover stranded investment is applied to**
22 **a limited customer base instead of being applied to all customers**
23 **statewide.**

24 Citizens and Staff both recognize that a mechanism needs to be put in place to
25 recover stranded costs. Citizens and Staff differ, however, on the customer base to which

27 ⁵ Under the framework contained in the draft proposal, there would be an
28 insufficient market for the kinds of transactions Staff foresees for willing buyers
 and sellers.

1 such a mechanism would be applied. The Staff proposal would limit the universe of potential
2 contributors to "customers who reduce or terminate service from the Affected Utility as a
3 direct result of competition governed by this Article, or who obtain lower rates from the
4 Affected Utility as a direct result of the provisions of this Article." Conversely, Citizens
5 proposes "a state mandated, non-bypassable [Investment Recovery Fund] Surcharge
6 collected at a dollars per kWh basis on all distribution company ("DISTCO") deliveries as a
7 separate line item on the bill."⁶

8 Citizens believes that stranded cost recovery from the statewide customer base is
9 superior to the limited universe of customers described in the draft rules. First, statewide
10 recovery "recognizes that the stranded costs are the result of the regulatory compact and that
11 all investments made by utilities in the past were approved by state regulators as being the
12 most appropriate option for the state at the time the decisions were made."⁷

13 Second, spreading the cost across all customers statewide would lessen the burden
14 on those who would bear the brunt of the charge under the draft rule. If stranded cost
15 recovery follows Staff's proposal, there is a very real concern that it would be detrimental to
16 smaller customers and those with low load factors because they may not be attractive to
17 serve in a competitive market.⁸

18 Third, determining stranded costs at one time (as Citizens has proposed through the
19 auction process) and then spreading those costs across all customers is a fairer, simpler and
20 more accurate approach than the continuous updating of the stranded cost calculation, as
21 proposed in the draft rules circulated by Staff.

22 Finally, if the draft rules became effective as currently written, they would have a
23 chilling effect on competition by serving as a substantial market barrier to those seeking to
24 obtain the benefits of competition.

25 ⁶ Citizens' June 28, 1996 Comments, p. 21 (emphasis added).

26 ⁷ Id.

27 ⁸ Citizens believes that small customers and other "undesirables" should have the
28 right to select their supplier, and not vice versa.

THE NEED FOR REDUCED REGULATION

CITIZENS' POSITION

In offering its June 1996 proposal, Citizens noted that it could not predict whether the costs associated with higher rates of return related to a free market would be less than the costs under the current regulated electric utility environment. The Company did conclude, however, that without reduced regulatory burdens, the savings projected by advocates of competition could not be realized:

[F]uture benefits will not be realized unless the present degree of regulation is decreased or the regulatory process is streamlined. If the overall regulatory and compliance burden placed on the future portions of the industry - both regulated and unregulated - equals or exceeds the present level, then many of the benefits of restructuring will be lost.⁹

THE STAFF PROPOSAL

Instead of relaxing or eliminating altogether regulatory oversight over a competitive electric marketplace, the draft rules retain for the Commission virtually the same degree of control that exists today. Perhaps the language in A.A.C. R14-2-xxx3(e)(1) best underscores the concern Citizens has in this area. That provision, which describes one of the obligations of a company holding a Certificate of Convenience and Necessity, states that such a company "shall comply with all Commission rules, orders, and other requirements relevant to the electric service and relevant to resource planning."

It is clear from that excerpt that if the draft rules were adopted, the Commission would continue to be involved in every facet of the operations of an Affected Utility as well as the operation of other market participants, including even resource planning. The point is that there should be fewer and fewer "rules, orders and other requirements" as competition takes hold. Moreover, if competition is to flourish, the Commission must be prepared to stand back and let the market work.

The reference to continued Commission oversight of electric resource planning is

⁹ Citizens' June 28, 1996 Comments, pp. 4-5.

1 another troubling matter. Under Citizens' proposal, DISTCOs would have the obligation to
2 connect, not the obligation to secure supply. In other words, DISTCOs would serve as the
3 conduit for the supply obtained thorough a retail company (RETAILCO) or a generation
4 company (GENCO). If a customer fails to obtain the requisite amount of power from one of
5 those two sources, the DISTCO's only obligation would be to obtain whatever power may be
6 available at the spot market price.

7 In Citizens' view, resource planning should be a function controlled by the competitive
8 markets. The market would dictate how much generation should be built and the mix of
9 generation alternatives. The risk/reward relationship of building new generation would be
10 governed by competitive market forces. Continued regulatory oversight of the resource
11 planning process has no place in a competitive market and raises the possibility of above-
12 market costs being placed on the back of electric utilities at a time when there is intense
13 pressure to reduce their exposure to stranded costs.¹⁰

14 Along the same lines, the Staff proposal includes a detailed set of regulations in A.A.C.
15 R14-2-xxx9 relating to the Solar Portfolio Standard. That provision would establish a
16 regulatory requirement that Affected Utilities and other market participants in Arizona must
17 derive at least 1% of the total retail energy sold competitively from new solar sources by
18 January 1, 1999, with the total increased to at least 2% by January 1, 2002. Reporting
19 requirements and penalty provisions are also included. Citizens believes that the competitive
20 markets should dictate the extent to which a company's generation portfolio would be
21 devoted to solar energy. As stated in its proposal, Citizens believes that such programs
22 should be funded by taxes or a statewide wires charge instead of appearing as a component
23 of an electric bill.

24 A.A.C. R14-2-xxx12 on rates poses another concern. While market-based rates for
25 competitive services are deemed to be just and reasonable according to A.A.C. R14-2-
26 xxx12(a), the provisions of that rule require each utility to file tariffs with maximum rates for

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28 ¹⁰ Citizens' June 28, 1996 Comments, p. 5.

1 those services. It also establishes a minimum rate as the marginal cost. The inconsistency
2 between the provisions is apparent and underscores the problems of "regulated competition."
3 If market-based rates are to be the standard, no artificial cap or rate maximum or minimum
4 should be imposed by the regulator. Viewed in another perspective, the imposition of a rate
5 maximum is tantamount to a vote of no confidence in competitive markets and suggests that
6 electric industry restructuring in Arizona is doomed to failure. It is not reasonable to subject
7 power sellers to the risks of competition while depriving them of market-based rewards for
8 being efficient.

9 There are numerous other instances in the draft rules of a pervasive regulatory
10 presence. These include: (1) reporting requirements in A.A.C. R14-2-xxx2(e)(3) and R14-2-
11 xxx14; (2) accounting requirements in A.A.C. R14-2-xxx2(e)(2); (3) working groups
12 overseeing reliability and safety issues in A.A.C. R14-2-xxx13; and (4) administrative
13 requirements in A.A.C. R14-2-xxx15. While some of these rules may be needed to manage
14 the transition to a competitive market, the general tone of the proposal is that the role of the
15 regulator will be significantly expanded well after so-called competition takes hold. For those
16 looking for signs of streamlined regulation and regulatory forbearance, the draft rules fall far
17 short of the mark.

18 **MISCELLANEOUS MATTERS**

19 **JURISDICTION**

20 Any electric industry restructuring proposal must recognize the jurisdictional limitations
21 of the states under our federal system. Through the enactment of the Federal Power Act,
22 Congress established a comprehensive legislative scheme for the regulation of electric
23 energy transmission and wholesale power sales in interstate commerce, and conferred upon
24 FERC exclusive jurisdiction over such transmission and sales. Since the transmission
25 facilities of electric utilities in Arizona are connected to the interstate grid, all transmission
26 that uses those facilities is subject to exclusive federal regulation under the Federal Power
27 Act.
28

1 Based upon the foregoing, pooling and dispatch arrangements for transmission and
2 generation of electricity are also subject to FERC jurisdiction. While states may engage in
3 collaborative efforts to assist the decision maker with regard to pooling and dispatch
4 arrangements, the ultimate determination on such matters rests exclusively with the FERC.
5 Sections A and C of A.A.C. R14-2-xxx12, Pooling of Generation and Centralized Dispatch of
6 Generation or Transmission, are consistent with the federal scheme because they merely
7 commit the Commission to "conduct an inquiry" and "work with other entities" on pooling and
8 centralized dispatch issues.

9 If Section B were enacted, however, the Commission would clearly be exceeding its
10 jurisdictional authority. That provision would empower the Commission to "establish a pool
11 for generation or centralized dispatch of generation or transmission by an independent
12 system operator or by other means." The establishment of a pool is within FERC's
13 jurisdiction and may not be preempted by the state. The draft rules should be revised to
14 remove this provision.

15 16 **LEVEL PLAYING FIELD**

17 The scheme adopted by the draft rules would be more onerous for Affected Utilities,
18 such as Citizens, than for other market participants. For instance, A.A.C. R14-2-xxx4(G)(4)
19 would impose a limit on the amount of the mark-up Affected Utilities may charge on any "buy
20 through," but would place no similar restriction on other suppliers. Similarly, A.A.C. R14-2-
21 xxx6 contains numerous requirements regarding services to be made available by Affected
22 Utilities. No corresponding provision can be found for other market participants. In addition,
23 the Solar Portfolio Standard is added to existing renewable requirements for Affected Utilities
24 only.

25 If Affected Utilities are to compete effectively, the new industry framework should not
26 be more burdensome for them than it is for their competitors. The benefits of competition
27 cannot be fully obtained unless a level playing field is maintained for all market participants,
28 and that level playing field must be apparent to the customer who would purchase energy in

1 such a market. The draft rules should be revised accordingly.

2 DUPLICATION OF EFFORT

3 A.A.C. R14-2xxx13(N) proposes that the Commission establish, by separate order, a
4 working group to monitor and review system reliability and safety. Staff's proposal would add
5 a redundant layer of regulatory oversight for both system reliability and safety.

6 The adequacy and reliability of the interconnected transmission system is within the
7 purview of the Western Systems Coordination Council ("WSCC") and the National Electric
8 Reliability Council ("NERC"). Committees of technical and operational experts have already
9 been formed and are presently functioning to establish appropriate planning and operating
10 criteria for interconnected system operations and to analyze all significant problems that may
11 arise. Annual reports are currently being provided to the Department of Energy through the
12 NERC for each of the seven reliability regions, including the WSCC.

13 Further, the existing Commission rules require electric systems to be constructed in
14 accordance with the National Electric Safety Code, the recognized standard throughout the
15 country. A network of industry experts continually reviews and periodically revises and
16 updates this standard to address changing needs for safeguarding the public. Other existing
17 federal and state statutes already cover employee safety.

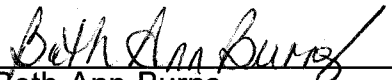
18 The addition of yet another working group, chaired by a Commission staff person, is
19 not expected to provide additional value and will certainly increase regulatory cost.
20 Therefore, A.A.C. R14-2xxx13(N) should be deleted.

21 CONCLUSION

22 While Citizens is an enthusiastic advocate of rapidly transitioning the electric industry
23 to a competitive environment, the draft rules circulated by Staff raise serious legal, policy,
24 and practical issues, as outlined herein. Citizens urges the Commission to carefully consider
25 the true significance of restructuring the electric industry in Arizona and, at a minimum, to
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1 revise the rules in accordance with these comments so that the undertaking will be
2 successful.

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4 Respectfully submitted,

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